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TAGS: ECON EFIN PGOV VE
SUBJECT: TO DEVALUE OR NOT TO DEVALUE, IS THAT THE QUESTION?

REF: A. 2007 CARACAS 2380
¶B. CARACAS 136
¶C. CARACAS 137
¶D. CARACAS 96
¶E. CARACAS 280

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) and (d).

¶1. (C) Summary: With the announcement of new economic policy measures expected by some over the next few weeks, speculation continues about whether the Government of the Bolivarian Republic of Venezuela (GBRV) will choose to devalue Venezuela's currency. Those who expect a devaluation in 2009 argue it is the quickest and surest way for the GBRV to cover a rapidly growing fiscal deficit. Those who do not expect it believe President Chavez sees devaluation as a last resort given its political costs. They note the GBRV can finance its deficit in other ways, such as issuing local debt or by selling dollars on the parallel market, a practice which amounts to a de facto devaluation but allows Chavez to save political face. We tend not to expect a formal devaluation in 2009 unless President Chavez becomes convinced low oil prices will last into 2010 and finds a politically acceptable way of selling a devaluation to the Venezuelan public. End summary.

The Rumbles Grow Louder

¶2. (U) In comments to the press the week of February 23, then Planning Minister Haiman El Troudi suggested the GBRV would announce new economic measures in the next several weeks. Over the following weekend, Chavez replaced El Troudi with Jorge Giordani (who was Planning Minister prior to El Troudi) and promised "a lot of work on economic issues" in the coming week. These statements, and Giordani's return to the cabinet, fueled speculation in the press of a devaluation, an action Minister of Finance Ali Rodriguez has consistently said he could not rule out.

¶3. (U) The GBRV has maintained a fixed exchange rate with currency controls since 2003. The rate was last adjusted in March 2005 to 2.15 bolivars (Bs) per USD. Since then, prices have risen over 110 percent, making the bolivar hugely overvalued at the official rate. Taking into account recent changes in price levels in Venezuela and in its main trading partners (i.e., using the real effective exchange rate method), local economists estimate the bolivar would be correctly valued at a nominal exchange rate of between 3.5

and 4 Bs/USD. As the bolivar is not freely convertible to USD at the official rate, a parallel foreign exchange market exists, with the current parallel rate at 5.7 Bs/USD. With the bolivar anywhere from 70 to 160 percent overvalued (depending on whether you use the real exchange rate method or the parallel rate as a comparator), it is no wonder economists consider the exchange rate to be the biggest single distortion (and source of corruption) in the Venezuelan economy.

The One Argument for a Devaluation

¶4. (U) Curiously enough, no one believes the GBRV will devalue to correct the economic imbalances caused by overvaluation. Were the GBRV concerned about these distortions, it would have devalued in 2008 or earlier. Instead, the GBRV seems content with an exchange rate policy that discourages exports and allows it to control who gets access to cheap dollars at the official rate for imports and other purposes. The economic actors impacted most negatively and directly by this policy are non-oil exporters and multinational companies, certainly not key constituencies of the GBRV. (Note: Exporters are punished because they are obliged to convert the dollars they receive to bolivars at the official rate. Multinational companies, who keep their books in dollars, cannot realize booked profits from Venezuelan operations if they cannot get access to dollars at the official rate to remit profits. End note.)

¶5. (U) Instead, those expecting a devaluation in 2009 argue it would be the most expedient way for the GBRV to finance a

huge predicted budget deficit in bolivars. What has changed since 2008, they argue, is not the GBRV's economic philosophy but rather oil prices. Taxes, royalties, and dividends from the petroleum sector provided roughly half of central government revenue in 2008, when the Venezuelan export basket averaged USD 87 per barrel. In the first two months of 2009, the basket averaged USD 36, a decline of almost 60 percent, and the volume of exports almost certainly declined slightly as well (due to OPEC-mandated cuts and other factors).

¶6. (SBU) Should these trends hold throughout the year, the GBRV will need to finance a central government deficit in 2009 that could reach 9 percent of GDP, or perhaps Bs 65 billion. Sintesis Financiera (SF), a respected local economic consultancy, estimates a 33 percent devaluation (to 2.86 Bs/USD) would yield additional revenue for the government in 2009 worth 5 percent of GDP (though SF's base case assumes an average oil price of USD 53 per barrel). Analysts predicting a devaluation in 2009 expect the new exchange rate will be fixed between 2.7 to 3.0 Bs/USD, enough to significantly reduce, but not eliminate, the GBRV's deficit. A devaluation in this range would not correct the bolivar's overvaluation at the official rate, and therefore the distortions mentioned above would remain. (Note: Predicting the GBRV's fiscal situation for 2009 is difficult for a variety of reasons. The numbers given in this cable should be taken as ballpark estimates. End note.)

The Several Arguments Against

¶7. (SBU) Though they acknowledge the fiscal benefits, most of our contacts do not expect a devaluation in 2009. Devaluation, they note, would have a high political cost to Chavez for two reasons. First and perhaps foremost, it represents the type of orthodox, "neoliberal" economic measure he despises and would clearly signal the failure of the "bolivar fuerte" ("strong bolivar"), an exercise in currency redenomination undertaken by the GBRV with much fanfare in 2008 (ref A). Second, our contacts argue, a

devaluation would have an immediate negative impact on inflation as it would cause an overnight increase in the average bolivar cost of imports. SF estimates a 33 percent devaluation would add 7 percentage points to inflation (which SF estimates at 40 percent for 2009 in the absence of a devaluation).

¶8. (SBU) Furthermore, our contacts believe the GBRV has room to manage its 2009 budget deficit without resorting to an official devaluation. Options include reduced spending (at least in real terms); increased taxes; issuance of local debt in bolivars (to be discussed further septel); drawing down of quasifiscal funds (and their replenishment through forward oil sales and transfer of Central Bank (BCV) reserves); and sales of dollars on the parallel market to generate more bolivars. Indeed, the GBRV has drawn upon each of these options in the first two months of 2009. It has reduced or stopped payments to certain suppliers, particularly in the petroleum and basic industries sectors (ref B); raised the "tax unit" (a multiplier to determine taxes owed) from Bs 46 to 55; sold several billion bolivars worth of local debt to banks; sold dollars on the parallel market through PDVSA (ref C); and almost certainly spent money in Fonden, the largest quasifiscal fund, which received a USD 12 billion transfer of reserves from the BCV in January (ref D). (Note: It is extremely hard to assess the extent to which the GBRV is resorting to these measures, except for taxation and local debt issuance. Most of the other measures involve actions which do not appear in the central government's balance sheet. End note.)

A De Facto Devaluation?

¶9. (SBU) Of course, all of the measures mentioned above have economic costs. Many of them will directly or indirectly contribute to inflation, thus nullifying in part one of the benefits of not devaluing. The transfer of reserves from the BCV to Fonden and the sale of dollars on the parallel market by PDVSA actually amount to a de facto devaluation. Both practices will reduce the amount of dollars available at the official rate for imports, thus pushing a greater percentage

of imports to the parallel market and increasing importers' weighted average exchange rate. Similarly, the sale of dollars on the parallel market by PDVSA (rather than to the BCV at the official rate) increases the average weighted exchange rate received by the government for its oil revenue. Most importantly, these and the other measures mentioned in paragraph 8 are probably not sustainable into 2010 without a major economic crisis (including inflation on the order of 60 percent or greater and/or shortages) ensuing if oil prices remain where they are.

Comment: Not So Simple a Question

¶10. (C) The question of whether the GBRV will devalue is clearly not as black and white as it first seems. Most economists would consider devaluation a no-brainer on strictly economic terms, both to correct the distortions of overvaluation and to reduce the deficit. President Chavez, as with all economic issues, approaches the question from an inherently political perspective. We agree with the majority of our contacts that President Chavez likely views devaluation as a last resort and that the GBRV has the ability to maage its budget shortfall in 2009 without devaluig the official rate.

¶11. (C) There is one condtion under which we might see a devaluation in 209, however. To date, most public statements of ey GBRV ministers, including Ali Rodriguez (Miniter of Finance) and Rafael Ramirez (Minister of Energy

and Petroleum), suggest a conviction that oil prices will rise substantially in the latter half of 2009. Chavez may be basing his political calculations vis-a-vis a devaluation on this expectation. If he becomes convinced oil prices will remain roughly steady well into 2010, his calculations may change as he realizes the steep price he would pay for his economic policies in 2010. Chavez might choose to bite the bullet sooner rather than later, and on his own terms. In this case, we might see a devaluation, but we doubt it would be part of a standard economic adjustment package. After all, President Chavez, too, would view a crisis as an opportunity. We expect a devaluation would be accompanied by more radical measures to expand the GBRV's control over the economy, all of which would be sold to Chavez' political base as necessary steps to protect Venezuelans from the evils of capitalism. His recent threats and actions against Cargill and Polar (ref E), Venezuela's leading food processors, may represent a trial balloon in this more radical direction. End comment.
CAULFIELD